

New Interagency Appraisal & Evaluation Guidelines: Practical Recommendations for Real Estate Appraisers

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Presentation Legend (code):

- *Italicized* fonts: Quoted Guideline excerpts
- Standard fonts: Guideline paraphrasing (e.g. “*an appraisal or evaluation*” = valuation; “*the appraiser or person who performed the evaluation*” = appraiser or evaluator)
- Recommendations: Speakers suggestions (includes editorializing)
- Potentially subjective interpretations

Interagency Guidelines:

Collective Agencies:

- Office of the Comptroller of the Currency (OCC)
- Federal Reserve System (FRB)
- Federal Deposit Insurance Corporation (FDIC)
- Office of Thrift Supervision (OTS)
- National Credit Union Administration (NCUA)

Appraisal Regulations:

- Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)
- Most recent regulatory amendments in June 1994

Interagency Guidelines (cont)

- 1994 Interagency Appraisal and Evaluation Guidelines
- Proposed Interagency Appraisal and Evaluation Guidelines issued in 2008
- New Guidelines finalized December 2, 2010 and supersede 1994 Guidelines

Interagency Guidelines (cont)

Purpose:

“These Guidelines, including their appendices, address supervisory matters relating to real estate appraisals and evaluations used to support real estate-related financial transactions...”

Regulators Perspective:

- Guidelines provide clarification, but do not represent significant changes in Agencies' expectations.
- Valuation policy & procedure (P&P) should be developed in accord; however, the Guidelines “*....allow for some flexibility to exist so long as an institution can demonstrate the independence of its collateral valuation function from the final credit decision.*” (separation between lending and appraisal function).

Valuation Program should:

Provide “...*independence of the persons ordering, performing, and reviewing...*”

“...*monitor the ongoing performance of appraisers...*”

“...*comply with the Agencies’ appraisal regulations...*”

“*Maintain criteria for the content and appropriate use of evaluations...*”

Valuation Program should (cont)

“Implement internal controls that promote compliance with these program standards, including those related to monitoring third party arrangements.”

“Establish criteria for monitoring collateral values.”

Recommendation No. 1:

Fee appraisers should use caution when discussing valuation assignments (or potential assignments) to be used for real estate loans with people outside the Bank's Appraisal Department.

When in doubt, politely refer these inquiries back to the Bank's Appraisal Department.

Valuation Program Independence:

Independence standards apply to both appraisal & evaluation.

P&P, “...*should specify methods for communication that ensure independence in the collateral valuation function.*”

Institution should not “...*coerce, influence, or otherwise encourage an appraiser or a person who performs an evaluation to misstate or misrepresent the value of the property.*”

P&P should “...*establish a process for responding to questions from the appraiser or person performing an evaluation.*”

Valuation Program Independence

(cont)

An institution may request valuator to:

- *“Consider additional information about the subject property or about comparable properties.”*
- *“Provide additional supporting information about the basis for a valuation.”*
- *“Correct factual errors in an appraisal.”*

Recommendation No. 2:

Review appraisers should:

- Establish a consistent process in their communications (e.g. email vs. telecom)
- Distinguish obvious mistakes (e.g. math errors) from potentially subjective matters (e.g. opinions)
- Ask open ended questions in a non-accusatory manner for subjective concerns.
- Be cautious of appearing to steer conclusions
- Customize the review scope (e.g. productive resolution of significant concerns)

Valuator Selection:

Criteria should ensure:

- “... *requisite education, expertise, and experience to competently complete the assignment.*”
- Their work, “...*is periodically reviewed by the institution.*”
- Appraisals must be performed by state licensed/certified appraisers (minimum criteria).

Valuator Selection (cont)

Evaluators should have appropriate “...*valuation education, expertise, and experience relative to the type of property being valued. Such persons may include appraisers, real estate lending professionals, agricultural extension agents, or foresters.*” (e.g. agents/brokers, property managers?)

“*An institution or its agent must directly select and engage appraisers.*” (& evaluators)

Recommendation No. 3:

Evaluators & Evaluations:

Licensed/Certified appraisers performing evaluations must comply with USPAP

A restricted use appraisal report could be augmented to satisfy evaluation requirements

Real estate agents, brokers &/or property managers may be qualified to perform evaluations. However, a Brokers Price Opinion (BPO) does not satisfy the requirements of an evaluation (e.g. market value definition, etc.)

Valuator Selection (cont)

Independence is compromised:

- “...*when a borrower recommends appraiser...*”
or evaluator.
- “...*when loan production staff selects a person to perform an appraisal or evaluation for a specific transaction.*”

Valuator Selection (cont)

“...regulations allow an institution to use an appraisal prepared for another financial services institution provided certain conditions are met.”

“An institution’s use of a borrower-ordered or borrower-provided appraisal violates the Agencies’ appraisal regulations. However, a borrower can inform an institution that a current appraisal exists, and the institution may request it directly from the other financial services institution.”

Recommendation No. 4:

Unsolicited Valuation Reports:

- Banks should develop P&P for releasing appraisals to & obtaining appraisals from other financial institutions
- Appraisers should use caution if contacted by non-client affiliated parties (e.g. another Bank)
- Engagement letters may be placed in report addenda.
- Unsolicited appraisals likely require a greater level of due-diligence (e.g. bona fides engagement verification)
- Reliance letters are not necessarily required.
- A new appraisal assignment(s) may be required.

Transactions Requiring Appraisals

“Most real estate-related financial transactions over the appraisal threshold are considered federally related transactions and, thus, require appraisals.”

Appendix A, identifies *“Appraisal Exemptions”*

Same as 1994 FIRREA

Minimum Appraisal Standards

Same five mandatory standards as (June 1994) before, but enhanced/clarified:

1st Standard: Must comply with USPAP

- Automated Valuation Model (AVM) & Broker Price Opinion (BPO) are not appraisals

2nd Standard: “*Be written and contain sufficient information and analysis to support the institution’s decision to engage in the transaction.*”

Minimum Appraisal Standards(cont)

An institution should:

“...be cautious in limiting the scope of the appraiser's inspection, research, or other information used...”

“...specify the use of a report option that is commensurate with the risk and complexity of the transaction. The appraisal report should contain sufficient disclosure of the nature and extent of inspection and research performed by the appraiser to verify the property's condition and support the appraiser's opinion of market value” (e.g. restricted use reports)

Recommendation No. 5:

Inspection Scope:

Advise on the extent of the inspection (e.g. exterior only, portions of interior, unit sampling)

Flag report if steered away or denied access to portions of a property

Identify & reconcile other sources (building plans, rent roll, property condition report)

If multiple parties sign or contribute to the report advise on the extent of their inspection (as above)

Minimum Appraisal Standards(cont)

3rd Standard: “*Analyze and report appropriate deductions for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments of unsold units.*”

Appendix C, “*Deductions and Discounts*” adds clarification

Minimum Appraisal Standards(cont)

4th Standard: “*Be based upon the definition of market value set forth in the appraisal regulation.*”

“*...opinions such as ‘going concern value,’ ‘value in use,’ or special value to a specific property user may not be used as market value... an appraisal may contain separate opinions of such values so long as they are clearly identified and disclosed.*”

Minimum Appraisal Standards(cont)

Must, “...*provide the property’s current market value in its ‘as is’ condition, and, as applicable, its prospective market value upon completion and/or prospective market value upon stabilization.*”

5th Standard: “*Be performed by state certified or licensed appraisers...*

“...*state certification or license is a minimum credentialing requirement [and]...appraiser may not be considered competent solely by virtue of being certified or licensed.*”

Recommendation No. 6:

Value Premises:

Recognize As-Is value assumes a sale (value in-exchange) & use value to (or credit of) the current owner may not be relevant

Clearly delineate non-realty components & analyze impact on real property value

Clearly label other value premises & should they be used to arrive at realty value recognize the sum of the parts doesn't always equal the whole (fee simple - leased fee \neq leasehold; going concern - personal property \neq real estate)

Recommendation No. 7:

Effective (Date of Value) Date(s):

As-Is Value should be based on most current date possible (e.g. current condition) without Hypothetical Conditions

Use caution in using Hypothetical Conditions on other value premises.

Be cognizant of growth assumptions and how they inflate prospective effective dates of value

Transactions Requiring Evaluations:

Same three exemptions as stated in 1994 Amendments to FIRREA.

Although “...*appraisal regulations allow use of evaluations for certain transactions, an institution should establish policies and procedures for determining when to obtain an appraisal for such transactions.*” (e.g. higher risk, atypical properties, properties located outside traditional lending market, extensions of credit with significant risk, etc.)

Evaluation Development:

“An institution should be able to demonstrate that an evaluation, whether prepared by an individual or supported by an analytical method or a technological tool, provides a reliable estimate of the collateral’s market value...”

Appendix B, *“Evaluations Based on Analytical Methods or Technological Tools”* adds clarification

Evaluation Development (cont)

“A valuation method that does not provide a property’s market value or sufficient information and analysis to support the value conclusion is not acceptable as an evaluation.”

Automated Valuation Models (AVMs), Competitive Market Analysis (CMAs), & Broker Price Opinions (BPOs) , *“...would not be acceptable as an evaluation.”*

“The information obtained from such sources may be useful to develop an evaluation or appraisal.”

Evaluation Content:

Added minimum content:

Still includes “*description of the property and its current and projected use.*”

Methods used to “*...confirm the property’s actual physical condition and the extent to which [of if] an inspection was performed.*”

“*Indicate all sources of information used in the analysis, as applicable, to value the property...*”

“*Include information on the preparer when an evaluation is performed by a person...*”

Reviewing Valuations:

New Agency Guideline section

“...an institution should review appraisals and evaluations to ensure that they comply with the Agencies’ appraisal regulations and are consistent with supervisory guidance and its own internal policies.”

Reviewing Valuations(cont)

P&P for reviewing, “...*at a minimum, should:*

- *Address the independence, educational and training qualifications, and role of the reviewer.*
- *Reflect a risk-focused approach for determining the depth of the review.*
- *Establish a process for resolving any deficiencies in appraisals or evaluations.*
- *Set forth documentation standards for the review and the resolution of noted deficiencies.”*

Reviewing Valuations(cont)

“An institution may find it appropriate to employ additional personnel or engage a third party to perform the reviews.”

“...complex properties or high-risk commercial loans should be reviewed more comprehensively to assess the technical quality of the appraiser’s analysis.”

“...an institution should establish criteria for when to expand the depth of the review.”

Reviewing Valuations(cont)

“...an institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, provided the institution determines that the appraisal conforms to the Agencies’ appraisal regulations... an institution should confirm...:

- The appraiser was engaged directly by the other financial services institution.*
- The appraiser had no direct, or prospective interest, financial or otherwise, in the property or transaction.*

Reviewing Valuations(cont)

- *The financial services institution (not the borrower) ordered the appraisal. For example, an engagement letter should show that the financial services institution, not the borrower, engaged the appraiser.”*

Establish P&P “... *for resolving any inaccuracies or weaknesses in an appraisal or evaluation identified through the review...[including]... :*

- *Communicating the noted deficiencies to and requesting corrections of such deficiencies...”*

Reviewing Valuations(cont)

- *“...insure that such communications do not result in any coercion or undue influence...”*
- *Addressing significant deficiencies in the appraisal that could not be resolved with the original appraiser by obtaining a second appraisal or relying on a review that complies with Standards Rule 3 of USPAP...”*

Review documentation *“...should provide an audit trail that documents the resolution of noted deficiencies or details the reasons for relying on a second opinion of market value.”*

Third Party Arrangements

“An institution should use caution if it engages a third party to administer any part of its appraisal and evaluation functions, including the ordering or reviewing of appraisals or evaluations, selecting an appraiser or [evaluator]... , or providing access to analytical methods or technological tools.”

Program Compliance:

“An institution should file a complaint with the appropriate state appraiser regulatory officials when it suspects that a state certified or licensed appraiser failed to comply with USPAP, applicable state laws, or engaged in other unethical or unprofessional conduct. In addition, effective April 1, 2011, an institution must file a complaint with the appropriate state appraiser licensing agency under certain circumstances.” (see 12 CFR 226.42(g) - this requires further Agency clarification)

Appendix A

“Appraisal Exemptions”:

“...the Agencies identified certain real estate-related financial transactions that do not require the services of an appraiser and that are exempt from appraisal requirement.”

Same twelve exemptions as stated in 1994 Amendments to FIRREA.

Appendix B

“Evaluations Based on Analytical Methods or Technological Tools”:

“An institution may use a variety of analytical methods and technological tools for developing an evaluation, provided the institution can demonstrate that the valuation method is consistent with safe and sound banking practices and these Guidelines.”

Discussion includes AVM’s & Tax Assessment Valuations (TAV’s).

Appendix C (cont)

“Deductions and Discounts”:

This concerns the third requirement in the five minimum appraisal standards requiring “...*an appraiser to analyze and report deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units.*”

Appendix C (cont)

“Deductions and Discounts” (cont):

“...an appraisal must include the market value of the property, which should reflect the property’s actual physical condition, use, and zoning designation (referred to as the ‘as is’ value of the property), as of the effective date of the appraisal. Therefore, if the highest and best use of the property is for development to a different use, the cost of demolition and site preparation should be considered in the analysis.”

Appendix C (cont)

“Proposed Construction or Renovation”

“...the sum of retail sales for a proposed development... is not the market value of the property for purposes of the Agencies’ appraisal regulations.”

Appendix C (cont)

“Partially Leased Buildings”

“...make appropriate deductions and discounts to reflect that the property has not achieved stabilized occupancy... include consideration of the absorption of the unleased space... include items such as leasing commission, rent losses, tenant improvements, and entrepreneurial profit, if such profit is not included in the discount rate.”

Appendix C (cont)

“Non-market Lease Terms”

“...clearly state the ownership interest being appraised and provide a discussion of the leases that are in place. If the leased fee interest is being appraised and contract rent is less than market rent on one or more long term lease(s) to a highly rated tenant, the market value of the leased fee interest would be less than the market value of the unencumbered fee simple interest in the property.” [warrants discussion]

Appendix C (cont)

“Tract Developments with Unsold Units”

“...tract development is defined...as a project of five units or more that is constructed or is to be constructed as a single development. Appraisals for these properties must reflect deductions and discounts for holding costs, marketing costs, and entrepreneurial profit supported by market data. In some cases entrepreneurial profit may be included in the discount rate.”

Appendix C (cont)

“In some markets, entrepreneurial profit is treated as a line item deduction while in other markets it is reflected as a component of the discount rate. Regardless of how entrepreneurial profit is handled in the appraisal analysis, an appropriate explanation and discussion should be provided in the appraisal report.”

Appendix C (cont)

- *“Raw Land. The appraiser must provide an opinion of value for raw land based on its current condition and existing zoning... [for developmental approach] the appraisal must reflect appropriate deductions and discounts for costs associated with developing and selling lots in the future... include items such as feasibility studies, permitting, engineering, holding costs, marketing costs, and entrepreneurial profit and other costs specific to the property.”*

Appendix C (cont)

“If sufficient market data exists to perform both the sales comparison and developmental approaches to value, the appraisal report should detail a reconciliation of these two approaches...”

- *“**Developed Lots**. ...five or more residential lots in a single development, the appraiser must analyze and report appropriate deductions and discounts... reflect holding costs, marketing costs, and entrepreneurial profit during the sales absorption period...”*

Appendix C (cont)

- **“Attached or Detached Single-family Homes.** ...five or more attached or detached single-family homes in the same development, the appraiser must analyze and report appropriate deductions and discounts... should reflect holding costs, marketing costs, and entrepreneurial profit during the sales absorption period...”

Appendix C (cont)

“If an institution finances construction on an individual unit basis, an appraisal of the individual units may be used if the institution can demonstrate through an independently obtained feasibility study or market analysis that all units collateralizing the loan can be constructed and sold within 12 months. However, the transaction should be supported by an appraisal that analyzes and reports appropriate deductions and discounts if any of the individual units are not completed and sold within the 12-month time frame.”

Appendix C (cont)

- “**Condominiums**. ...condominium building[s] with five or more units, the appraisal must reflect appropriate deductions and discounts, holding costs, marketing costs, and entrepreneurial profit during the sales absorption period of the completed units. If an institution finances construction of a single condominium building with less than five units or a condominium project with multiple buildings with less than five units per building,

Appendix C (cont)

the institution may rely on appraisals of the individual units if the institution can demonstrate through an independently obtained feasibility study or market analysis that all units collateralizing the loan can be constructed and sold within 12 months. However, the transaction should be supported by an appraisal that analyzes and reports appropriate deductions and discounts if any of the individual units are not completed and sold within the 12-month time frame.”

Recommendation No. 8:

Entrepreneurial Profit:

AKA = unearned entrepreneurial profit.

Entrepreneur brings the elements of land, labor and capital together, and accordingly, an incentive or reward is justified for this effort.

Regardless of property type being valued, a profit incentive should be considered for every non-performing/non-stabilized property (existing & proposed)

Appendix D

“Glossary of Terms”:

Contains 49 applicable definitions. Two interesting ones (not included in USPAP) are:

“Effective Date of the Evaluation – For the purposes of the Agencies’ appraisal regulations and these Guidelines, the effective date of an evaluation is the date that the analysis is completed.”

Recommendation No. 9:

Key Valuation Dates:

Since both appraisals and evaluations require confirmation of “...*the property’s actual physical condition and the extent to which an inspection was performed.*” Always report three key dates: (1) effective date (of value), (2) report date and (3) inspection date.

Consider using the most current inspection date as the effective date (of value) for the As-Is value premise.

Appendix D

“*Glossary of Terms*” (cont)

“***Going Concern Value*** – *The value of a business entity rather than the value of the real property. The valuation is based on the existing operations of the business and its current operating record, with the assumption that the business will continue to operate.*”

Recommendation No. 10:

Going Concern Value:

Definition terminology is inconsistent with other sources

Business owned or leased real estate may be part of a going concern value.

It may be inappropriate (misleading) not to, at least partially, address going concern in a real estate appraisal assignment (e.g. inadequate revenue to support special purpose realty improvements)

The End

